Initial Statement of Reasons

Adoption of Proposed Amendments to
California Code of Regulations, Title 18, Section 1684,
Collection of Use Tax by Retailers

SPECIFIC PURPOSE AND NECESSITY

Current Regulation 1684 and Current Section 6203

California Code of Regulations, title 18, section (Regulation) 1684, *Collection of Use Tax by Retailers*, requires "[r]etailers engaged in business in this state as defined in Section 6203" of the Revenue and Taxation Code (section[1] 6203) to register with the State Board of Equalization (Board), collect California use tax from their California customers, and remit the use tax to the Board. The regulation also provides that such retailers are liable for California use taxes that they fail to collect from their customers and remit to the Board.

Current Provisions of Section 6203
Currently, the operative provisions of section 6203, subdivision (c)(1) through (3), define the term "retailer engaged in business in this state" by providing that:

> "Retailer engaged in business in this state" as used in this section and Section 6202 means and includes any of the following:
> (1) Any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business.
> (2) Any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property.
> (3) As respects a lease, any retailer deriving rentals from a lease of tangible personal property situated in this state. (Current section 6203, subd. (c)(1)-(3).)

The current operative provisions of section 6203, subdivision (d)(1), address the taking of orders over the Internet by providing that:

> For purposes of this section, "engaged in business in this state" does not include the taking of orders from customers in this state through a

[1] All further section references are to the Revenue and Taxation Code, unless otherwise indicated.

> computer telecommunications network located in this state which is not directly or indirectly owned by the retailer when the orders result from the electronic display of products on that same network. The exclusion provided by this subdivision shall apply only to a computer telecommunications network that consists substantially of online communications services other than the displaying and taking of orders for products.

In addition, the current operative provisions of section 6203, subdivision (e) provide that a retailer is not a "retailer engaged in business in this state" if that retailer's "sole physical presence in this state" is to engage in limited convention and trade show activities, as specified.

Current Provisions of Regulation 1684

Currently, Regulation 1684 does not define the full scope of the phrase "retailer engaged in business in this state," as defined in section 6203. Instead, Regulation 1684, subdivision (a), provides, in relevant part, the following guidance regarding the meaning of the phrase "retailer engaged in business in this state," as currently defined by section 6203, subdivisions (c) and (d):

> Any retailer deriving rentals from a lease of tangible personal property situated in this state is a "retailer engaged in business in this state" and is required to collect the tax at the time rentals are paid by his lessee.
>
> The use of a computer server on the Internet to create or maintain a World Wide Web page or site by an out-of-state retailer will not be considered a factor in determining whether the retailer has a substantial nexus with California. No Internet Service Provider, On-line Service Provider, internetwork communication service provider, or other Internet access service provider, or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.
>
> A retailer is not "engaged in business in this state" based solely on its use of a representative or independent contractor in this state for purposes of performing warranty or repair services with respect to tangible personal property sold by the retailer, provided that the ultimate ownership of the representative or independent contractor so used and the retailer is not substantially similar. For purposes of this paragraph, "ultimate owner" means a stock holder, bond holder, partner, or other person holding an ownership interest.

Regulation 1684, subdivision (b), also incorporates the current provisions of section 6203, subdivision (e) regarding convention and tradeshow activities.

Section 6203 as Amended by Assembly Bill No. 155

Assembly Bill No. (AB) 155 (Stats. 2011, ch. 313) was enacted on September 23, 2011, and section 3 of AB 155 will amend the definition of "retailer engaged in business in this state," as set forth in current section 6203. Section 6 of AB 155 provides that the amendments made to section 6203 will become operative on September 15, 2012, if a federal law is not enacted on or before July 31, 2012, authorizing the states to require a seller to collect taxes on sales of goods to in-state purchasers without regard to the location of the seller. However, if a federal law is enacted on or before July 31, 2012, authorizing the states to require a seller to collect taxes on sales of goods to in-state purchasers without regard to the location of the seller, and the state does not, on or before September 14, 2012, elect to implement that law, the amendments made to section 6203 by AB 155 will become operative on January 1, 2013.

Section 6203, subdivision (c), as amended by AB 155, will define the term "retailer engaged in business in this state" more broadly then current section 6203, subdivision (c), and provide that the term means "any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty."

Section 6203, subdivision (c)(1) through (3), as amended by AB 155, will provide that the term "retailer engaged in business in this state" specifically includes, but is not limited to, retailers engaged in the activities described in current section 6203, subdivision (c)(1) through (3) (quoted above). Subdivision (c)(4), as added to section 6203 by AB 155, will further provide that "retailer engaged in business in this state" specifically includes, but is not limited to, any retailer that is a member of a "commonly controlled group" as defined in section 25105, and is a member of a "combined reporting group," as defined by the Franchise Tax Board (FTB) in Regulations 25106.5, subdivision (b)(3), "that includes another member of the retailer's commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer, performs services in this state in connection with tangible personal property to be sold by the retailer . . . ."

In addition, subdivision (c)(5)(A), as added to section 6203 by AB 155, will provide that the term "retailer engaged in business in this state" specifically includes, but is not limited to "[a]ny retailer entering into an agreement or agreements under which a person or persons in this state, for a commission or other consideration, directly or indirectly refer potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet Web site, or otherwise," but only if: (1) "The total cumulative sales price from all of the retailer's sales, within the preceding 12 months, of tangible personal property to purchasers in this state that are referred pursuant to all of those agreements with a person or persons in this state, is in excess of ten thousand dollars ($10,000)"; and (2) "The retailer, within the preceding 12 months, has total cumulative sales of tangible personal property to purchasers in this state in excess of one million dollars ($1,000,000)."

However, subdivision (c)(5)(B), as added to section 6203 by AB 155, will provide that: "An agreement under which a retailer purchases advertisements from a person or persons in this state, to be delivered on television, radio, in print, on the Internet, or by any other medium, is not an agreement described in subparagraph (A), unless the advertisement revenue paid to the person or persons in this state consists of commissions or other consideration that is based upon sales of tangible personal property." Subdivision (c)(5)(C), as added to section 6203 by AB 155, will provide that: "Notwithstanding subparagraph (B), an agreement under which a retailer engages a person in this state to place an advertisement on an Internet Web site operated by that person, or operated by another person in this state, is not an agreement described in subparagraph (A), unless the person entering the agreement with the retailer also directly or indirectly solicits potential customers in this state through use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of direct or indirect solicitation specifically targeted at potential customers in this state." Subdivision (c)(5)(D), as added to section 6203 by AB 155, will provide that for purposes of paragraph (c)(5), "retailer" includes "an entity affiliated with a retailer within the meaning of Section 1504 of the Internal Revenue Code." Also, subdivision (c)(5)(E), as added to section 6203 by AB 155, will provide that paragraph (c)(5) "shall not apply if the retailer can demonstrate that the person in this state with whom the retailer has an agreement did not engage in referrals in the state on behalf of the retailer that would satisfy the requirements of the commerce clause of the United States Constitution."

Finally, it should be noted that the amendments made to section 6203 by AB 155 will also repeal the provisions in current section 6203, subdivision (d), regarding the "taking of orders from customers in this state through a computer telecommunications network," and renumber current section 6203, subdivision (e)'s provisions regarding convention and tradeshow activities as section 6203, subdivision (d).

Substantial Nexus

Physical Presence Test

Article I, section 8, clause 3 of the United States Constitution expressly authorizes the United States Congress to "regulate Commerce with foreign Nations, and among the several States" (Commerce Clause). In *Quill Corporation v. North Dakota* (1992) 504 U.S. 298, the United States Supreme Court explained that:

- The Commerce Clause grants Congress affirmative legislative authority and, by its own force, prohibits certain state actions that interfere with interstate commerce (*Id.* at p. 309);
- Subject to Congress's legislative authority, the Commerce Clause prohibits a state from requiring a retailer engaged in interstate commerce to collect the state's use tax unless the retailer has a "substantial nexus" with the state (see *id.* at p. 311);
- In the absence of congressional action, the bright line rule, established in *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois* (1967) 386 U.S. 753, that a retailer must have a "physical presence" in a taxing

state in order for that state to impose a use tax collection obligation on the retailer is still applicable today (see *id*. at pp. 317-318); and

- *National Bellas Hess* interpreted the Commerce Clause as establishing a "safe harbor" prohibiting a state from requiring a retailer to collect that state's use tax if the retailer's only connection with customers in the state is by common carrier or the United States mail, which, in the absence of congressional action, is still applicable today (see *id*. at p. 315).

Historically, the United States Supreme Court has agreed that the safe harbor established in *National Bellas Hess* (and reaffirmed in *Quill*) is limited and does not apply when a retailer's "connection with the taxing state is not exclusively by means of the instruments of interstate commerce." (*National Geographic Society v. California Board of Equalization* (1977) 430 U.S. 551, 556 [quoting from and affirming the California Supreme Court's decision in *National Geographic Society v. State Board of Equalization* (1976) 16 Cal.3d 637, 644].) The United States Supreme Court has specifically found that the safe harbor does not apply to an out-of-state retailer that has established a place of business in the taxing state, even if the retailer's in-state business activities are unrelated to the retailer's sales of tangible personal property to customers in that state. (*Id*. at p. 560.) The United States Supreme Court has specifically explained that the safe harbor does not apply if a retailer attempts to negate its connection with a taxing state by organizing itself or its activities in such a way as to "departmentalize" its connection with the taxing state so that the connection is isolated from the retailer's obvious selling activities. (*Id*. at pp. 560-561.) This is so regardless of whether the connection involves an in-state person who may be characterized as an employee, agent, representative, salesperson, solicitor, broker, or independent contractor, and regardless of whether the activities creating the connection are directly related to the retailer's sales of tangible personal property to customers in the state. (*Ibid*.; see also *Scripto, Inc. v. Carson Sheriff* (1960) 362 U.S. 207, 211-212.) The United States Supreme Court has also specifically found that the safe harbor does not apply if a retailer has "property within [the taxing] State." (*National Geographic Society*, *supra*, 430 U.S. at p. 559 [quoting *National Bellas Hess*].)

Further, the California Supreme Court previously held that "the slightest [physical] presence" in California would be sufficient to create a substantial nexus between a retailer and this state. (*National Geographic Society*, *supra*, 16 Cal.3d at p. 644.) However, the United States Supreme Court did not agree with the California Supreme Court's slightest presence standard on appeal (*National Geographic Society*, *supra*, 430 U.S. at p. 556). Subsequently, the United States Supreme Court held that a retailer did not have a substantial nexus with a taxing state solely because the retailer licensed a few customers to use software on a few floppy disks located within the taxing state. (*Quill*, *supra*, 504 U.S. at p. 315, fn. 8.)

More recently, the Court of Appeals of New York (i.e., New York's highest appellate court) explained that, while the "physical presence" test affirmed in *Quill* requires that a retailer have more than the slightest physical presence in a state before that state can require the retailer to collect the state's use tax, the physical presence "does not need to

be substantial" and "it may be manifested by the presence in the taxing State of the [retailer's] property or the conduct of economic activities in the taxing State performed by the [retailer's] personnel or on its behalf." (*Orvis Co., Inc., v. Tax Appeals Tribunal of the State of New York et al.* (1995) 86 N.Y.2d 165, 178.) Furthermore, the California Court of Appeal expressly agreed with and followed the Court of Appeals of New York's construction of the physical presence test in *Borders Online, LLC. v. State Board of Equalization* (2005) 129 Cal.App.4th 1179, 1198-1199. And, the California Court of Appeal further explained that activities performed in California by or on behalf of a retailer will be sufficient to satisfy the physical presence test if they enhance the retailer's sales to California customers and significantly contribute to the retailer's ability to establish and maintain a market in California. (*Id*. at p. 1196.)

Commonly Controlled Group Nexus

The Board is aware that, in *Current, Inc. v. State Board of Equalization* (1994) 24 Cal.App.4th 382, the California Court of Appeal held that an out-of-state corporate retailer with no stores, solicitors, or property within California does not have a physical presence in California solely because it is acquired by another corporation that is a retailer with a physical presence. However, in that case, the California retailer's activities did not give the out-of-state retailer a physical presence in California because:

- Neither entity was the alter ego or agent of the other for any purpose;
- Neither entity solicited orders for the products of the other, and neither accepted returns of the merchandise of the other or otherwise assisted or provided services for customers of the other;
- Each entity owned, operated, and maintained its own business assets, conducted its own business transactions, hired and paid its own employees, and maintained its own accounts and records;
- Neither entity held itself out to customers or potential customers as being the same as, or an affiliate of, the other;
- Each entity had its own trade name, goodwill, marketing practices and customer lists and marketed its products independently of the other; and
- Neither purchased goods or services from the other. (*Id*. at p. 388.)

The Board does not believe that the holding in *Current* affects the validity of the new commonly controlled group nexus provisions of section 6203, subdivision (c)(4), that will become operative on September 15, 2012, or January 1, 2013, which provide that a retailer is engaged in business in California if: (1) the retailer is a member of a commonly controlled group, as defined in section 25105; and (2) the retailer is a member of a combined reporting group, as defined in Franchise Tax Board Regulation 25106.5, subdivision (b)(3), that includes "another member of the retailer's commonly controlled group that, ***pursuant to an agreement with or in cooperation with the retailer, performs services in this state in connection with tangible personal property to be sold by the retailer***, including, but not limited to, design and development of tangible personal

property sold by the retailer, or the solicitation of sales of tangible personal property on behalf of the retailer." (Emphasis added.)

This is because the United States Supreme Court agreed with the Washington Supreme Court, in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue* (1987) 482 U.S. 232, 250-251, that a retailer has a substantial nexus with a taxing state if there are persons in that state performing activities on behalf of the retailer that enable the retailer to "establish and maintain a market." Additionally, in 2005, the California Court of Appeal subsequently quoted *Tyler Pipe* before concluding that an out-of-state retailer organized as a limited liability company (LLC) had a substantial nexus with California because a separate corporation, affiliated with the LLC through a common parent, performed activities in California on behalf of the retailer that were significantly associated with the retailer's ability to establish and maintain its California market. (*Borders Online, supra*, 129 Cal.App.4th at pp. 1196, 1197.) Accordingly, the Board believes that the California Court of Appeal's holding in *Current* would have been different if the in-state corporation had performed services in California in connection with tangible personal property to be sold by the out-of-state corporation, pursuant to an agreement with or in cooperation with the out-of-state corporation (i.e., if the provisions of section 6203, subdivision (c)(4) (emphasized above) had been operative and satisfied in that case).

Affiliate Nexus

The State of New York has enacted an affiliate nexus statute that is similar to the provisions of section 6203, subdivision (c)(5), as add by AB 155. The New York statute creates a rebuttable presumption that a retailer is soliciting business in New York through an independent contractor or other representative and is required to register to collect New York use tax if the retailer enters into an agreement with a resident of New York under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet website or otherwise, to the retailer, if the retailer's cumulative gross receipts from sales to customers in New York who were referred to the retailer by residents with the requisite agreements is in excess of $10,000 during the four proceeding quarters. (N.Y. Tax Law § 1101, subd. (b)(8)(vi).) The New York statute also provides that the presumption may be rebutted by proof that the resident with whom the retailer has an agreement did not engage in any solicitation in the state on behalf of the retailer "that would satisfy the nexus requirement of the United States constitution during the four quarterly periods in question." (*Ibid*.)

Amazon.com LLC filed a lawsuit in New York seeking declaratory and injunctive relief on the ground that the New York statute is unconstitutional on its face because, among other things, it allegedly violates the Commerce Clause; however, when the Supreme Court of New York County (i.e., a New York trial court) denied the relief, Amazon.com LLC dropped its facial challenge and appealed the trial court's decision on other grounds, including the ground that the New York statute allegedly violates the Commerce Clause as applied to Amazon.com LLC. (*Amazon.com, LLC, et al. v. New York State Department of Taxation and Finance* 2010 N.Y. Slip Opn. 7823.) Overstock.com, Inc. also filed a lawsuit in New York seeking injunctive and declaratory relief on the ground

that that the New York statute is unconstitutional on its face because, among other things, it allegedly violates the Commerce Clause; and when the Supreme Court of New York County denied the relief, Overstock.com, Inc. argued that the statute allegedly violates the Commerce Clause both on its face and as applied to Overstock, Inc. when it appealed the Supreme Court of New York County's decision. (*Overstock.com, Inc. v. New York State Department of Taxation and Finance* 2010 N.Y. Slip Opn. 7823.)

Amazon.com, LLC's and Overstock.com, Inc.'s appeals were consolidated into one matter before the Appellate Division of the Court of Appeals of New York (i.e., an intermediate appellate court) and jointly decided on November 4, 2010. (2010 N.Y. Slip Opn. 7823.) In that decision, the Appellate Division denied Overstock.com, Inc.'s facial challenge because the court concluded that the New York statute is consistent with the "physical presence" test, which was affirmed in *Quill* and discussed at length in *Orvis*, in that the New York statute only requires a retailer to register to collect New York use tax if the retailer enters into a business-referral agreement with a New York resident, the resident actively solicits business in New York, as opposed to merely posting a passive advertisement, and the resident receives a commission based upon the sales successfully solicited in New York. (2010 N.Y. Slip Opn. 7823, at pp. 8-10.) However, the Appellate Division remanded the as-applied challenges back to the trial court for discovery.

The Board believes that, after remand back to the trial court for further factual development, both Amazon.com, LLC and Overstock.com, Inc. may continue to press their objections to the Appellate Division's decision to the Court of Appeals of New York (i.e., New York's highest appellate court). However, in the meantime, the New York State Department of Taxation and Finance has issued Technical Services Bureau Memorandum TSB-M-08(3)S (May 8, 2008), which explains the rebuttable presumption in the New York statute and provides that the "Tax Department will deem the presumption rebutted where the [retailer] is able to establish that the only activity of its resident representatives in New York State on behalf of the [retailer] is a link provided on the representatives' Web sites to the [retailer's] Web site and none of the resident representatives engage in any solicitation activity in the state targeted at potential New York State customers on behalf of the [retailer]." And, TSB-M-08(3)S further provides that "an agreement to place an advertisement does not give rise to the presumption"; however, "placing an advertisement does not include the placement of a link on a Web site that, directly or indirectly, links to the Web site of a [retailer], where the consideration for placing the link on the Web site is based on the volume of completed sales generated by the link."

The New York State Department of Taxation and Finance also issued Technical Services Bureau Memorandum TSB-M-08(3.1)S (June 30, 2008), which provides that a retailer may rebut the presumption that it has nexus under the New York statute by meeting both of the following conditions:

1. Contract condition – Showing that the contract or agreement between the retailer and the resident representative provides that the resident representative is prohibited from engaging in any solicitation activities in New York that refer potential customers to

the retailer, including, but not limited to, distributing flyers, coupons, newsletters and other printed promotional materials, or electronic equivalents, verbal soliciting (e.g., in-person referrals), initiating telephone calls, and sending e-mails, and, if the resident representative is an organization (such as a club or a nonprofit group), showing that the contract or agreement also provides that the organization will maintain on its Web site information alerting its members to the prohibition against each of the solicitation activities described above; and

2. Proof of compliance condition – Showing that each resident representative has submitted to the retailer, on an annual basis, a signed certification stating that the resident representative has not engaged in any prohibited solicitation activities in New York, as described above, at any time during the previous year, and, if the resident representative is an organization, that the annual certification also include a statement from the resident organization certifying that its Web site includes information directed at its members alerting them to the prohibition against each of the solicitation activities described above.

However, as to the proof of compliance condition, a signed certification from a resident representative may only be used to rebut the presumption in the New York statute if the retailer accepts it in good faith (i.e., the retailer does not know or have reason to know that the certificate is false or fraudulent).

In addition, the Board is aware that subdivision (a)(1) of Regulation 1540, *Advertising Agencies and Commercial Artists*, provides that: "Advertising is commercial communication utilizing one or more forms of communication (such as television, print, billboards, or the Internet) from or on behalf of an identified person to an intended target audience." The Board is also aware that, in the administrative appeal of Barnes & Noble.com, LLC, the Board had to determine whether certain in-state activity constituted "advertising" or "selling." In the Memorandum Opinion the Board adopted to decide the Barnes & Noble.com appeal, the Board stated that "an 'advertisement' is a 'written, verbal, pictorial, graphic, etc., announcement of goods or services for sale, employing purchased space or time in print or electronic media.'" However, the Board also concluded that when California employees of Barnes & Noble Booksellers, Inc. (B&N Booksellers), physically distributed coupons to B&N Booksellers' customers, which could only be used to make discounted purchases from Barnes & Noble.com (B&N.com), the acts of physically distributing the coupons directly to the potential customers of B&N.com were solicitations of those persons, and went beyond mere advertising to the public at large. (Memorandum Opinion, *Barnes & Noble.com*, adopted September 12, 2002.)

Furthermore, the Board is aware that Ballentine's Law Dictionary (3d ed. 2010 LexisNexis) provides that the word "advertise" means "[t]o make known to the public through a medium of publicity that one's goods or services are available for sale or engagement." In addition, Ballentine's Law Dictionary (3d ed. 2010 LexisNexis) defines the word "solicit" as "to invite a business transaction" or "[t]o importune, entreat, implore, ask, attempt, or try to obtain an order" and defines the phrase "solicitation of business" as "seeking orders for goods or services."

Adoption of Regulation 1684's Current Website Provisions
The Board adopted the current provisions of Regulation 1684, subdivision (a), regarding computer servers, websites, and Internet service providers on September 10, 1997. The Final Statement of Reasons for the adoption of the provisions provides that:

> In recent years, two business practices have arisen which raise the issue as to whether or not the retailers practicing them thus became engaged in business in this state. First, some out-of-state retailers have established Web Sites (electronic files maintained on computers called servers) on the World Wide Web, part of the Internet, for the purpose of making sales. The Internet evolved from a Defense Department project in the late 1960's, and has grown to be a world-spanning network of at least 60,000 smaller, independent computer networks linked by satellites, coaxial cable, and phone lines. The World Wide Web is a smaller network of hyperlinked documents within the Internet. (Yahoo! Internet Life (8/97), p. 62) Servers mainly belong to service providers, either Independent Service Providers (ISP's), or national commercial on-line services like Prodigy or America On-Line. The server on which the Web Site is located may or may not be sited in California. Confusion has arisen as to whether or not an in-state ISP who hosts an out-of-state retailer's Web Site is a "representative" within the meaning of Section 6203(b) for use tax collection purposes and, if so, whether the exemption contained in Section 6203(j), whereby nexus is not provided by a retailer's use of an on-line service for the purpose of taking orders for tangible personal property if the primary purpose of the service is not the sale of tangible personal property, applies to a retailer's Web Site carried by a general-interest ISP which hosts a myriad of Web Sites as well as to a proprietary on-line service. Legislation has been introduced to clarify these principles, but none has yet been enacted. As more and more business is being conducted on the Internet, the Board concluded that it was necessary to resolve this issue by regulation to bring some certainty to this area pending legislative action. Upon consultation with industry, the Board concluded that a Web Site is a utility service operating through communications lines to forward a buyer's order to the retailer, so that orders placed through a Web Site should be treated for nexus purposes like orders placed through the mail which the United States Supreme Court has determined does not provide "nexus." (Quill Corporation v. North Dakota (1992) 504 U.S. 298.) The Board also concluded that the Legislature did intend that Section 6302(j) apply to Web Sites hosted by ISP's as well as to proprietary networks.

As a result, the Board's adoption of the current provisions in Regulation 1684, subdivision (a), regarding the use of computer servers, websites, and Internet service providers was based upon the Board's 1997 interpretation of *Quill* and not solely the express language of subdivision (d) of current section 6203, which will be inoperative on September 15, 2012, or January 1, 2013, due to the provisions of AB 155. However, the

Board's Legal Department's current opinion is that an out-of-state retailer that owns a computer server in California (as opposed to merely purchasing web services through a third party's servers) has a place of business in California where the server is located and is, thus, obligated to collect California use tax, under the current (and continuing) provisions of section 6203, subdivision (c)(1).

Warranty and Repair Services
The Board adopted the current provisions of Regulation 1684, subdivision (a), regarding warranty and repair services on September 10, 1997. The Final Statement of Reasons for the adoption of the provisions provides that:

> [M]any retailers have entered into contracts with instate businesses to perform repair services on such retailers' products purchased by buyers who are residents of this state.
>
> Again, a controversy has arisen as to whether or not these independent contractors are "representatives" of such retailers within the meaning of Section 6203(b) for use tax collection purposes. Upon researching this issue, the Board determined that such repairmen do not qualify under established United States Supreme Court cases as representatives for nexus purposes because they do not participate in the transfer of the property from the out-of-state retailer to the in-state customer but, rather, become involved with the property after (sometimes long after) the sale transaction is concluded. As more and more out-of-state retailers are out-sourcing their warranty responsibilities to instate independent contractors rather than maintaining in-state repair facilities, and no statute addresses this issue, the Board concluded that it was necessary for it to bring certainty to this issue by regulatory action.

As a result, the Board's adoption of the current provisions in Regulation 1684, subdivision (a) regarding warranty and repair services was based upon the Board's 1997 interpretation of United States Supreme Court cases.

Interested Parties Process

Initial Interested Parties Meetings
During the Board's Business Taxes Committee meeting on July 26, 2011, the Board directed its staff to review ABx1 28 (Stats. 2011, ch.7), which made almost identical amendments to section 6203 as AB 155 and conduct interested parties meetings to discuss whether the Board should amend Regulation 1684 to implement, interpret, and make specific the amendments made to section 6203 by ABx1 28. However, before staff could begin the interested parties process, the Legislature repealed the amendments made to section 6203 by ABx1 28 and enacted the amendments made to section 6203 by AB 155 (discussed above). Therefore, Board staff reviewed AB 155 and Regulation 1684 and then conducted meetings with interested parties on October 31, 2011, in Sacramento,

California, and November 2, 2011, in Culver City, California, to discuss staff's initial suggestions that Regulation 1684 needs to be amended to:

- Incorporate the new provisions of section 6203 regarding substantial nexus, including provisions addressing commonly controlled group nexus and affiliate nexus;
- Incorporate the physical presence test established in *National Bellas Hess* (and affirmed in *Quill*) by creating a rebuttable presumption that, unless otherwise provided in Regulation 1684, a retailer is required to collect California use tax if the retailer has any physical connection to California besides a connection with customers in California that is exclusively by means of interstate commerce, such as by common carrier or the United States mail or interstate telecommunication;
- Define the terms "advertisement," "solicit," and "solicitation" for purposes of applying the new provisions of section 6203 by focusing on the general and broad nature of advertising and the more actively targeted nature of soliciting;
- Explain that the phrases "commission or other consideration" and "commissions or other consideration that is based upon sales of tangible personal property," as used in the new affiliate nexus provisions of section 6203, refer to commissions or other consideration that is based upon completed sales of tangible personal property, similar to the provisions of New York's affiliate nexus statute, as interpreted by TSB-M-08(3)S;
- Create a means by which a retailer may effectively establish that its agreement with a person in California is not the type of agreement that can give rise to affiliate nexus under new section 6203 by utilizing contractual terms and factual certifications that are similar to the contractual terms and factual certifications that a retailer can use to rebut New York's presumption that a retailer has affiliate nexus due to an agreement with a New York resident;
- Clarify that an out-of-state retailer that owns a computer server in California and uses the California server to maintain its webpage where it makes retail sales (as opposed to a retailer that merely purchases web services through a third party's servers) has a substantial nexus with California (i.e., a place of business in California where the server is located) and is, thus, obligated to collect California use tax; and
- Provide that the amendments made to Regulation 1684 to implement the nexus-expanding provisions of AB 155 will become operative when new section 6203 becomes operative on September 15, 2012, or January 1, 2013, and shall not have a retroactive effect.

And, to discuss Board staff's initial suggestions that the Board:

- Retain the current provisions of Regulation 1684 regarding Internet service providers, online service providers, internetwork communication service providers, other Internet access service providers, and World Wide Web hosting services based upon the Board's 1997 interpretation of *Quill*; and

- Retain the current provisions of Regulation 1684 regarding "warranty and repair services" based upon the Board's 1997 interpretation of United States Supreme Court cases.

After reviewing Board's staff's suggestions, the interested parties recommended:

- Revising staff's suggested amendments adding subdivision (c)(2) to Regulation 1684 to incorporate the commonly controlled group nexus provisions of new section 6203, subdivision (c)(4), so that subdivision (c)(2) of the regulation defines the phrase "in cooperation with," as used in new section 6203, subdivision (c)(4), so that it only refers to activities performed directly for or on behalf of a retailer, and clarifies that new section 6203, subdivision (c)(4) only applies when a member of an out-of-state retailer's commonly controlled group is performing in-state services that enable the out-of-state retailer to create or maintain an in-state market;
- Revising staff's suggested amendments incorporating the affiliate nexus provisions of new section 6203, subdivision (c)(5), into Regulation 1684 in order to: (A) define the phrase "person or persons in this state" so that it only refers to an individual that is a California resident or a business legal entity that is commercially domiciled or headquartered in California; (B) clarify that creating a sales and use tax collection obligation based on the presence of an in-state person who refers customers must be limited to those in-state persons who are performing activities to establish or maintain a California market; (C) clarify the phrase "other consideration"; (D) explain what the phrases "directly or indirectly," "indirectly solicit," "indirect solicitation," and "or otherwise" mean with examples; (E) clarify whether a static link that is labeled "click here" constitutes a solicitation; and (F) explain that the method of compensation should not convert an otherwise permissible advertisement into a market-making activity that leads to nexus;
- Revising staff's suggested amendments creating a means by which a retailer may effectively establish that its agreement with a person in California is not the type of agreement that can give rise to affiliate nexus under new section 6203, subdivisions (c)(5), by utilizing contractual terms and factual certifications so that: (A) the contractual terms do not prohibit an advertising agreement from providing for the payment of commissions based upon completed "click-through" sales; and (B) retailers are excused from obtaining certificates where it would be impossible to do so, for example, where the in-state person is deceased; and
- Deleting staff's suggested amendments to Regulation 1684's website provisions because the amendments may violate the Internet Tax Freedom Act (ITFA), and deleting staff's suggested amendments adding subdivision (b)(2) to Regulation 1684 because the rebuttable presumption in subdivision (b)(2) may be inconsistent with the United States Supreme Court's view of the Commerce Clause.

In addition, staff received a written comment, which noted that Senator Hancock and Assembly Members Blumenfield, Calderon, and Skinner published statements of intent in the September 9, 2011, Assembly Daily Journal to memorialize their understanding that the provisions of section 6203, subdivision (c)(5)(A)-(C), were intended to:

> [D]raw a clear line between activities that are "mere advertising" versus more sufficiently meaningful in-state activity that should properly be characterized as "soliciting business" for purposes of meeting the definition of a "retailer engaged in business in this state." Given the evolving nature of online advertising, and the anonymous manner in which it may be delivered to online customers, it is important to note that, in isolation, online advertising, including those ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailer websites, and similar online advertising services should not be considered a "referral" under subparagraph (5)(A), nor "direct or indirect solicitation specifically targeted at potential customers in the state" under subparagraph (5)(C). Those types of advertising services are generated as a result of generic algorithmic functions and are anonymous and passive in nature and thus do not rise to the level of referring or soliciting business. Agreements for such advertising services are not covered, unless the person entering the agreement also engages in other activities on behalf of the retailer in this state – such as sending flyers or making phone calls – that are specifically targeted at customers in this state.

The written comment also recommended revising staff's suggesteded amendments incorporating the affiliate nexus provisions of new section 6203, subdivision (c)(5), into Regulation 1684 so that the amendments further provide that the terms "solicit" and "solicitation" do not include "online advertising, including those ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailer websites and similar online advertising services."

Board staff agreed to revise its suggested amendments adding subdivision (c)(2) to Regulation 1684 to define the phrase "in cooperation with" and clarify that subdivision (c)(2) only applies when a member of an out-of-state retailer's commonly controlled group is performing in-state "services" that help the out-of-state retailer to establish or maintain a California market for sales of tangible personal property because the United States Supreme Court and the California Court of Appeal have held that these types of in-state services establish a substantial nexus in *Tyler Pipe* and *Borders Online*, respectively. Therefore, staff added a new paragraph (c)(2)(B)(i) to its suggested amendments to Regulation 1684 to provide that "services are performed in connection with tangible personal property to be sold by a retailer if the services help the retailer establish or maintain a California market for sales of tangible personal property." Staff also added new paragraph (c)(2)(B)(ii) to its suggested amendments to Regulation 1684 to define "in cooperation with" in accordance with the general definition of the term, which is that "cooperation" is "an act or instance of working or acting together for a common purpose or benefit." (Dictionary.com.)

Board staff also generally agreed that the phrase "other consideration" should be further clarified. Therefore, Board staff revised its suggested amendments incorporating the affiliate nexus provisions into Regulation 1684 so that they further explain that the consideration referred to in section 6203, subdivision (c)(5), as added by AB 155, is any "consideration that is based upon completed sales of tangible personal property, whether referred to as a commission, fee for advertising services, or otherwise."

Further, Board staff generally agreed that the method of compensation should not convert an otherwise permissible advertisement into a market-making activity that establishes a substantial nexus. Therefore, Board staff revised its suggested amendments explaining how a retailer may effectively establish that its agreement with a person in California is not the type of agreement that can give rise to affiliate nexus so that the amendments do not prohibit an agreement from providing for the payment of commissions.

Moreover, Board staff generally agreed that retailers should be excused from obtaining certificates to establish that their in-state affiliates did not perform prohibited solicitation activities in California under appropriate circumstances, including where the person required to make the certification is deceased. Therefore, Board staff revised its suggested amendments so that the amendments excuse retailers from having to obtain a certification if the person from whom the certification is required is dead, lacks the capacity to make such certification, or cannot reasonably be located by the retailer and there is no evidence to indicate that such person did in fact engage in any prohibited solicitation activities in California at any time during the previous year.

Additionally, after reviewing the statements of intent published by Senator Hancock and Assembly Members Blumenfield, Calderon, and Skinner in the September 9, 2011, Assembly Daily Journal in detail and interpreting the amendments made to section 6203 by AB 155 in light of the statements of intent, staff concluded that:

- Based on the language in subdivision (c)(5)(B) of section 6203, subdivision (c)(5)(A)'s new affiliate nexus provisions *do not apply* to agreements under which a retailer purchases advertisements from a person in this state to be delivered on television, radio, in print, on the Internet, or by any other medium when the advertisement revenue paid to the person *is not based* on commissions or other consideration that is based upon completed sales of tangible personal property. However, the affiliate nexus provisions of new subdivision (c)(5)(A) *do apply* to such agreements when the advertisement revenue paid *is based* on commissions or other consideration that is based upon completed sales of tangible personal property.

- Based on the language in subdivision (c)(5)(C) of section 6203, subdivision (c)(5)(A)'s new affiliate nexus provisions *do not apply* to agreements under which a retailer engages a person in this state to place an advertisement on an Internet website operated by that person, or operated by another person in this state, if the person entering into the agreement with the retailer *does not* directly or indirectly

solicit potential customers in this state through the use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of direct or indirect solicitation specifically targeted at potential customers in this state. However, the affiliate nexus provisions of subdivision (c)(5)(A) *do apply* to such agreements when the person directly or indirectly *does* solicit potential customers in California through such means.

- The Senator and Assembly Members intended for the new provisions of section 6203, subdivision (c)(5)(A)-(C) "to draw a clear line between activities that are 'mere advertising' versus more sufficiently meaningful in-state activity that should properly be characterized as 'soliciting business' for purposes of meeting the definition of a 'retailer engaged in business in this state.'"

- The Senator and Assembly Members did not intend for section 6203, subdivision (c)(5)(A)'s new affiliate nexus provisions to apply to an agreement under which a retailer purchases online advertising generated as a result of generic algorithmic functions that is anonymous and passive in nature, such as anonymous and passive ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailers' websites, and similar online advertising services. In short, the Senator and Assembly members have implicitly presumed that persons who enter into this type of agreement with a retailer generally do not directly or indirectly solicit potential customers for the retailer in California.

In other words, staff concluded that the Legislature intended to create a distinction between "traditional" advertising contracts (i.e., contracts for the sale of advertising space or time with no presumed solicitation) and potentially "nexus-producing" contracts that are not limited to the sale or purchase of traditional advertising (i.e., commission-based contracts with presumed solicitation). Staff also concluded that the Senator and Assembly members believed that anonymous and passive online advertising should be viewed as traditional advertising so that out-of-state retailers will not be required to register with the Board to collect use tax solely because they purchase anonymous and passive online advertising. Therefore, staff generally agreed that staff's suggested amendments to Regulation 1684 should clarify that: (1) the term "advertisement" includes anonymous and passive online advertising, such as anonymous and passive ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailer websites, and similar online advertising; and (2) the terms "solicit," "solicitation," "refer," and "referral" do not include the same types of anonymous and passive online advertising.

However, Board staff did not agree with all of the interested parties comments. Board staff concluded that the proper administration of the amendments made to section 6203, subdivision (c), by AB 155, requires that the Board establish a presumption that a retailer is engaged in business in California if the retailer has any physical connection to California besides a connection with customers in California that is exclusively by means of interstate commerce, such as by common carrier, the United States mail, or interstate telecommunication (i.e., a presumption that a retailer is "engaged in business in

California" if the retailer has any in-state physical presence). Retailers can rebut this presumption by establishing that their physical presence in California is so slight that it cannot create a substantial nexus within the meaning of the Commerce Clause. Furthermore, Board staff concluded that the rebuttable presumption set forth in staff's suggested amendments adding subdivision (b)(2) to Regulation 1684 is consistent with the physical presence test established in *National Bellas Hess* (and reaffirmed in *Quill*) because the presumption only applies when a retailer has a physical presence in California and the presumption that the physical presence creates a substantial nexus and corresponding use tax collection obligation can be rebutted if the retailer can show that its physical presence is so slight that it will not satisfy the physical presence test established in *National Bellas Hess* (and reaffirmed in *Quill*). Therefore, staff did not delete the rebuttable presumption from its suggested amendments adding subdivision (b)(2) to Regulation 1684.

Board staff did not agree that the phrase "person or persons in this state" needs to be defined so that it only refers to "an individual that is a California resident or a business legal entity that is commercially domiciled or headquartered in California." The term "person" is broadly defined by section 6005 and the recommended definition is inconsistent with that section. Furthermore, an individual does not need to be a resident of California and a legal entity does not need to be headquartered or domiciled in California in order to perform services in this state.

Board staff did not agree to define the terms "directly," "indirectly," and "otherwise" because these are all broad terms with generally applicable meanings. However, Board staff indicated that it was open to further discussion regarding adding examples to Regulation 1684 that would help clarify the meaning of these terms.

Furthermore, Board staff found that ITFA, as renewed in 2007, imposes a moratorium on the states' imposition of two categories of taxes during the period beginning November 1, 2003, and ending November 1, 2014:

- Taxes on internet access, which means taxes imposed on a service that enable users to connect to the Internet to access content, information, or other services offered over the Internet, whether imposed on the provider or the consumer; and
- Multiple or discriminatory taxes on electronic commerce. (ITFA §§ 1101(a), 1105(5).)

ITFA provides that the term "tax" includes "the imposition on a seller of an obligation to collect and to remit to a governmental entity any sales or use tax imposed on a buyer by a governmental entity." (ITFA § 1105(8).) ITFA provides that "[t]he term 'multiple tax' means any tax that is imposed by one State or political subdivision thereof on the same or essentially the same electronic commerce that is also subject to another tax imposed by another State or political subdivision thereof (whether or not at the same rate or on the same basis), without a credit (for example, a resale exemption certificate) for taxes paid in other jurisdictions." However, the term "multiple tax" does "not include a sales or use tax imposed by a State and 1 or more political subdivisions thereof on the same electronic

commerce or a tax on persons engaged in electronic commerce which also may have been subject to a sales or use tax thereon." (ITFA § 1105(6)(A) & (B).) ITFA further provides that "The term 'discriminatory tax' means –

> (A) any tax imposed by a State or political subdivision thereof on electronic commerce that – (i) is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means; (ii) is not generally imposed and legally collectible at the same rate by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means, unless the rate is lower as part of a phase-out of the tax over not more than a 5-year period; (iii) imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means; (iv) establishes a classification of Internet access service providers or online service providers for purposes of establishing a higher tax rate to be imposed on such providers than the tax rate generally applied to providers of similar information services delivered through other means; or
>
> (B) any tax imposed by a State or political subdivision thereof, if – (i) the sole ability to access a site on a remote seller's out-of-State computer server is considered a factor in determining a remote seller's tax collection obligation; or (ii) a provider of Internet access service or online services is deemed to be the agent of a remote seller for determining tax collection obligations solely as a result of – (I) the display of a remote seller's information or content on the out-of-State computer server of a provider of Internet access service or online services; or (II) the processing of orders through the out-of-State computer server of a provider of Internet access service or online services. (ITFA § 1105(2).)

ITFA also provides that except as expressly provided, "nothing in this title shall be construed to modify, impair, or supersede, or authorize the modification, impairment, or superseding of, any State or local law pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal law and in effect on the date of enactment of this Act." (ITFA § 1101(b).)

Therefore, Board staff did not agree that its suggested amendments to Regulation 1684's website provisions violate ITFA. This is because the amendments cannot reasonably be interpreted to impose taxes on Internet access, or multiple or discriminatory taxes within the above ITFA definitions. Board staff also concluded that the suggested amendments merely recognize that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state. Further, Board staff concluded that the suggested amendments do not discriminate against Internet access

providers or electronic commerce retailers because whatever use tax collection obligation may be imposed as a result of the amendments:

- Is generally imposed and legally collectible by California, at the same rate, on transactions involving similar property and goods accomplished through other means involving the presence of a retailer's property in this state; and
- Will not be imposed on a different person or entity than in the case of transactions involving similar property and goods accomplished through other means.

In addition, Board staff concluded that the suggested amendments will not require a retailer to collect California use tax solely because California consumers can access the retailer's "out-of-State computer server" via the Internet or deem a provider of Internet access service or online services to be the agent of a retailer for determining the retailer's use tax collection obligation solely as a result of the display of the retailer's information or content on "the out-of-State computer server of a provider of Internet access service or online services" or the processing of orders through "the out-of-State computer server of a provider of Internet access service or online services."

Subsequent Interested Parties Meetings
Board staff conducted additional meetings with interested parties on December 20, 2011, in Sacramento, California, and December 22, 2011, in Culver City, California, to further discuss the comments and responses summarized above, and staff's revisions to its original suggested amendments to Regulation 1684. After the additional interested parties meetings, the interested parties recommended that Board staff:

1. Delete the rebuttable presumption from the suggested amendments adding subdivision (b)(2) to Regulation 1684 or replace the reference to "physical connection" with a reference to "physical presence" in the suggested amendments in order to make the rebuttable presumption more consistent with the "physical presence" test established in *National Bellas Hess* (and reaffirmed in *Quill*).
2. Further clarify when a person or persons are "in this state" within the meaning of section 6203, subdivision (c)(5)(A), as added by AB 155, and clarify that subdivision (c)(5)(A) only applies to a retailer when there is a person who is conducting referral "activities in California" that help the retailer establish or maintain a California market.
3. Include examples in the suggested amendments to Regulation 1684 to clarify whether the in-state activities described therein will or will not constitute the "indirect solicitation" of California customers within the meaning of section 6203, subdivision (c)(5)(C), as added by AB 155.
4. Consider adding "unless the computer server located in California is owned or leased by the out-of-state retailer" to the end of the first sentence in Regulation 1684's current provisions regarding webpages and Internet services providers, instead of staff's suggested amendments revising the same sentence so that it begins with the phrase "The use of an unrelated third party's computer server . . . ."

Board staff agreed that the suggested amendments adding subdivision (b)(2) to Regulation 1684 would be more clear if the term "physical connection" was replaced with the term "physical presence" from the "physical presence" test established in *National Bellas Hess* (and reaffirmed in *Quill*). In addition, Board staff concluded that it would be helpful if subdivision (b)(2) to Regulation 1684 explained how a retailer with a "physical presence" in California can rebut the presumption that it has a "substantial nexus" with and therefore is engaged in business in California (i.e., by establishing that its physical presence in California is so slight that a finding of substantial nexus would not be constitutionally permissible). Board staff also concluded that it would be helpful to add an additional subdivision (b)(3) to Regulation 1684 to further clarify that a retailer does not have a physical presence in California solely because the retailer engages in interstate communications with customers in California via common carrier, the United States mail, or interstate telecommunication, including, but not limited to, interstate telephone calls and emails, and that the rebuttable presumption does not apply to a retailer that does not have a physical presence in California. Therefore, Board staff revised its suggested amendments adding subdivision (b) to Regulation 1684, accordingly.

Board staff further agreed that it would be helpful if the suggested amendments to Regulation 1684 clarified when a person is "in this state" within the meaning of section 6203, subdivision (c)(5)(A), as added by AB 155. In addition, Board staff concluded that it would be helpful if Regulation 1684 further clarified that subdivision (c)(3), as suggested to be added to Regulation 1684, only applies to a retailer when an individual solicits potential customers under the retailer's agreement while the individual is physically present within the boundaries of California, and that such additional clarification would help ensure that subdivision (c)(3) is interpreted and administered consistently with *Tyler Pipe* and *Borders Online*. Therefore, Board staff suggested adding a new subdivision (c)(5) to Regulations 1684 to further clarify when an individual is in this state within the meaning of section 6203, subdivision (c)(5)(A), and adding a new subdivision (c)(6) to Regulation 1684 to clarify when subdivision (c)(3) of Regulation 1684 applies. Board staff also suggested adding new subdivision (c)(8)(B) and (C) to Regulation 1684 to define the term "individual" as referring to a "natural person" and define the term "person" by reference to the definition in section 6005.

Additionally, Board staff agreed that it would be helpful to add examples to Regulation 1684 to illustrate the application of subdivision (c)(3), as suggested to be added to Regulation 1684, and provide examples of "direct and indirect" solicitation within the meaning of subdivision (c)(3). Therefore, Board staff suggested adding subdivision (c)(9) to Regulation 1684 to provide examples that staff believes will be helpful to illustrate when the "direct and indirect" solicitation activities are present that are necessary to create "affiliate nexus" under subdivision (c)(3).

Finally, staff agreed with the alternative amendments to the first sentence in Regulation 1684's current provisions regarding webpages and Internet service providers and staff incorporated the alternative amendments into its suggested amendments to Regulation 1684. Staff concluded that the alternative amendments achieve staff's intended purpose,

which was to amend the provisions regarding webpages and Internet service providers to recognize that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state.

Proposed Amendments

At the conclusion of the interested parties process, Board staff prepared Formal Issue Paper 12-003, which raised the issue of whether the Board should amend Regulation 1684 to implement, interpret, and make specific the amendments made to section 6203 by section 3 of AB 155 (the problem to be addressed for purposes of Government Code section 11346.2, subdivision (b)(1)), summarized the interested parties process discussed above, and recommended that the Board amend Regulation 1684 to:

- Incorporate the new provisions of section 6203, subdivision (c), as amended by AB 155, providing that "retailer engaged in business in this state" means "any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty," and incorporate the non-exhaustive examples of retailers with substantial nexus set forth in section 6203, subdivision (c)(1)-(5), as amended by AB 155, including the examples regarding commonly controlled group nexus and affiliate nexus;
- Incorporate the physical presence test established in *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois* (1967) 386 U.S. 753 (and affirmed in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298) by creating a presumption that a retailer is engaged in business in this state if the retailer has any physical presence in California, and further explain that a retailer may rebut the presumption if the retailer can substantiate that its physical presence is so slight that the United States Constitution prohibits this state from imposing a use tax collection duty on the retailer, that a retailer does not have a physical presence in California solely because the retailer engages in interstate communications with customers in California via common carrier, the United States mail, or interstate telecommunication, including, but not limited to, interstate telephone calls and emails, and that the rebuttable presumption does not apply to a retailer that does not have a physical presence in California;
- Clarify that services are performed in connection with tangible personal property to be sold by a retailer, within the meaning of section 6203, subdivision (c)(4)'s new commonly controlled group nexus provisions, if the services help the retailer establish or maintain a California market for sales of tangible personal property, and clarify that services are performed in cooperation with a retailer, within the meaning of section 6203, subdivision (c)(4), as added by AB 155, if the retailer and the member of the retailer's commonly controlled group performing the services are working or acting together for a common purpose or benefit;
- Clarify that the phrases "commission or other consideration" and "commissions or other consideration that is based upon sales of tangible personal property," as used in section 6203, subdivision (c)(5)'s new affiliate nexus provisions, refer to

any "consideration that is based upon completed sales of tangible personal property, whether referred to as a commission, fee for advertising services, or otherwise," similar to the provisions of New York's affiliate nexus statute, as interpreted by TSB-M-08(3)S;

- Clarify that the determination as to whether a retailer has made the requisite amount of sales to purchasers in California during the preceding 12 month period to be engaged in business in California under section 6203, subdivision (c)(5)'s new affiliate nexus provisions shall be made at the end of each calendar quarter;
- Clarify that, for purposes of section 6203, subdivision (c)(5)'s new affiliate nexus provisions, an individual is in California when the individual is physically present within the boundaries of California and a person other than an individual is in California when there is at least one individual physically present in California on the person's behalf, and further clarify that the affiliate nexus provisions do not apply to a retailer's agreement with any person, unless an individual solicits potential customers under the agreement while the individual is physically present within the boundaries of California, including, but not limited to, an individual who entered into the agreement directly with the retailer, an individual, such as an employee, who is performing activities in California directly for a person that entered into the agreement with the retailer, and any individual who is performing activities in California indirectly for any person who entered into the agreement with the retailer, such as an independent contractor or subcontractor;
- Create a means by which a retailer may effectively establish that its agreement is not the type of agreement that can give rise to affiliate nexus under section 6203, subdivision (c)(5) by utilizing contractual terms and factual certifications that are similar to the contractual terms and factual certifications that a retailer can use to rebut New York's presumption that a retailer has affiliate nexus due to an agreement with a New York resident; and expressly excuse retailers from obtaining a certification if the person from whom the certification is required is dead, lacks the capacity to make such certification, or cannot reasonably be located by the retailer and there is no evidence to indicate that such person did in fact engage in any prohibited solicitation activities in California at any time during the previous year;
- Define the terms "advertisement," "solicit," and "solicitation" for purposes of applying the new affiliate nexus provisions of section 6203, subdivision (c)(5) by focusing on the general and broad nature of advertising and the more actively targeted nature of soliciting, and making the definitions for the terms "advertisement," "solicit," "solicitation," "refer" and "referral" consistent with staff's understanding of section 6203, subdivision (c)(5), and Senator Hancock's and Assembly Members Blumenfield's, Calderon's, and Skinner's intent;
- Define the term "person" by reference to the definition of "person" set forth in section 6005 and define the term "individual" to mean a "natural person" for purposes of applying the new affiliate nexus provisions of section 6203, subdivision (c)(5);

- Provide three examples illustrating the application of the new affiliate nexus provisions of section 6203, subdivision (c)(5);
- Recognize and provide notice that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state; and
- Provide that the amendments made to Regulation 1684 to implement the nexus-expanding provisions of AB 155 will become operative when new section 6203 becomes operative on September 15, 2012, or January 1, 2013, and shall not have a retroactive effect.

Formal Issue Paper 12-003 also contained staff's recommendations that the Board:

- Retain the other current provisions of Regulation 1684 regarding Internet service providers, online service providers, internetwork communication service providers, other Internet access service providers, and World Wide Web hosting services based upon the Board's 1997 interpretation of *Quill*; and
- Retain the current provisions of Regulation 1684 regarding "warranty and repair services" based upon the Board's 1997 interpretation of United States Supreme Court cases.

Business Taxes Committee Meeting

The Board considered Formal Issue Paper 12-003 during its February 28, 2012, Business Taxes Committee meeting, and the Board voted to propose the adoption of staff's recommended amendments because the Board determined that the amendments are reasonably necessary for the specific purposes of:

- Making Regulation 1684 consistent with the amendments made to section 6203 by AB 155;
- Providing notice to retailers that California will be a "substantial nexus state" (impose the obligation to collect California use tax to the fullest extent permitted by the Commerce Clause) and that a retailer with a physical presence in California will be required to register to collect California use tax, unless the retailer can show that its physical presence is so slight that the Commerce Clause will not permit California to impose a use tax collection obligation on the retailer or the retailer is otherwise exempt from registering to collect use tax, when the amendments made to section 6203 by AB 155 are operative;
- Incorporating the new commonly controlled group nexus provisions added to section 6203, subdivision (c)(4), by AB 155, defining the phrase "in cooperation with" as used in subdivision (c)(4), and clarifying that subdivision (c)(4) only applies when a member of an out-of-state retailer's commonly controlled group is performing in-state "services" that help the out-of-state retailer to establish or maintain a California market for sales of tangible personal property;
- Incorporating the new affiliate nexus provisions added to section 6203, subdivision (c)(5), by AB 155; clarifying the phrases "commission or other consideration" and "commissions or other consideration that is based upon sales

of tangible personal property," as used in section 6203, subdivision (c)(5); clarifying that the determination as to whether a retailer has made the requisite amount of sales to purchasers in California during the preceding 12 month period to be engaged in business in California under section 6203, subdivision (c)(5) shall be made at the end of each calendar quarter; clarifying that, for purposes of section 6203, subdivision (c)(5), an individual is in California when the individual is physically present within the boundaries of California and a person other than an individual is in California when there is at least one individual physically present in California on the person's behalf; clarifying that the affiliate nexus provisions do not apply to a retailer's agreement with any person, unless an individual solicits potential customers under the agreement while the individual is physically present within the boundaries of California; creating a means by which a retailer may effectively establish that its agreement is not the type of agreement that can give rise to affiliate nexus under section 6203, subdivision (c)(5) by utilizing contractual terms and factual certifications; defining the terms "advertisement," "individual," "person," "solicit," and "solicitation" for purposes of applying section 6203, subdivision (c)(5); and providing examples illustrating the application of the new affiliate nexus provisions of section 6203, subdivision (c)(5);

- Recognizing and providing notice that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state; and
- Providing that the amendments made to Regulation 1684 to implement the nexus-expanding provisions of AB 155 will become operative when new section 6203 becomes operative on September 15, 2012, or January 1, 2013, and shall not have a retroactive effect.

The proposed amendments are anticipated to provide the following benefits:

1. Ensure that Regulation 1684 is consistent with the provisions of new section 6203, when new section 6203 becomes operative;
2. Give needed guidance to retailers as to whether their activities create a "substantial nexus" with California and will require them to register with the Board to collect use tax when new section 6203 becomes operative;
3. Ensure that new section 6203 is interpreted and administered consistently with United States Supreme Court and California court opinions regarding substantial nexus, including, but not limited to, *National Bellas Hess*, *Quill*, *Tyler Pipe*, S*cripto*, *National Geographic Society*, *Current*, and *Borders Online*; ans
4. Ensure that new section 6203's affiliate nexus provisions will be interpreted and administered consistently.

The proposed amendments to Regulation 1684 were not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulation 1684.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 12-003, all but one of the exhibits to the formal issue paper, and the comments made during the Board's discussion of the formal issue paper during its February 28, 2012, Business Taxes Committee meeting in deciding to propose the amendments to Regulation 1684 described above. During the committee meeting, Betty T. Yee, Board Member for the Board's First Equalization District and Business Taxes Committee Chairwoman, acknowledged Senator Hancock's and Assembly Members Blumenfield's, Calderon's, and Skinner's statements of intent published in the September 9, 2011, Assembly Daily Journal, and included in exhibit 3 to Formal Issue Paper 12-003. However, Ms. Yee noted that the statements were letters expressing the Senator's and Assembly Members' personal intent, not binding statements of the entire Legislature's intent included in operative provisions of AB 155, and that, regardless of the statements, technology is changing and the Board has the discretion to revisit the issue of whether online advertising may constitute soliciting within the meaning of section 6203 if technology changes so that future online advertising is not necessarily the result of algorithmic functions that are anonymous and passive in nature. Furthermore, the Board voted to clarify in the rulemaking record that the statements of intent are not supporting documents (authority or reference) for the proposed amendments.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1684 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed amendments at this time because the Board determined that the amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1684 that would lessen any adverse impact the proposed action may have on small business or that would be lessen burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(6) AND ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

Sections 6203 and 6226 collectively require a "retailer engaged in business in this state" to register with the Board and collect California use tax from its California customers.

Also, section 6204 makes a retailer personally liable for any California use tax it fails to collect from its California customers, as required by section 6203.

Regulation 1684 currently requires "[r]etailers engaged in business in this state as defined in Section 6203" to register with the Board, collect California use tax from their California customers, and remit the use tax to the Board. The regulation also provides that such retailers are liable for California use taxes that they fail to collect from their customers and remit to the Board. Regulation 1684 does not currently regulate the health and welfare of California residents, worker safety, or the state's environment.

Section 6203, subdivision (c), as amended by AB 155, will define the term "retailer engaged in business in this state" more broadly then current section 6203, subdivision (c), and the amendments made by AB 155 will become operative on either September 15, 2012, or January 1, 2013. New subdivision (c) will provide that the term "retailer engaged in business in this state" means "any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty" and provide that retailers with substantial nexus, include, but are not limited to, retailers with commonly controlled group nexus and affiliate nexus (as discussed in detail above). Therefore, any retailer that has a "substantial nexus" with California, including a retailer with commonly controlled group nexus or affiliate nexus, will be required to register with the Board to collect California use tax when the amendments made to section 6203 by AB 155 become operative, regardless of whether the Board adopts the proposed amendments.

The proposed amendments to Regulation 1684 will help retailers better understand whether they are obligated to register to collect California use tax when the amendments made to section 6203 by AB 155 become operative by:

- Making Regulation 1684 consistent with the amendments made to section 6203 by AB 155;
- Providing notice to retailers that California will be a "substantial nexus state" and that a retailer with a physical presence in California will be required to register to collect California use tax, unless the retailer can show that its physical presence is so slight that the Commerce Clause will not permit California to impose a use tax collection obligation on the retailer or the retailer is otherwise exempt from registering to collect use tax, when the amendments made to section 6203 by AB 155 are operative;
- Incorporating the new commonly controlled group nexus provisions added to section 6203, subdivision (c)(4), by AB 155, defining the phrase "in cooperation with" as used in subdivision (c)(4), and clarifying that subdivision (c)(4) only applies when a member of an out-of-state retailer's commonly controlled group is performing in-state "services" that help the out-of-state retailer to establish or maintain a California market for sales of tangible personal property;
- Incorporating the new affiliate nexus provisions added to section 6203, subdivision (c)(5), by AB 155; clarifying the phrases "commission or other

consideration" and "commissions or other consideration that is based upon sales of tangible personal property," as used in section 6203, subdivision (c)(5); clarifying that the determination as to whether a retailer has made the requisite amount of sales to purchasers in California during the preceding 12 month period to be engaged in business in California under section 6203, subdivision (c)(5) shall be made at the end of each calendar quarter; clarifying that, for purposes of section 6203, subdivision (c)(5), an individual is in California when the individual is physically present within the boundaries of California and a person other than an individual is in California when there is at least one individual physically present in California on the person's behalf; clarifying that the affiliate nexus provisions do not apply to a retailer's agreement with any person, unless an individual solicits potential customers under the agreement while the individual is physically present within the boundaries of California; creating a means by which a retailer may effectively establish that its agreement is not the type of agreement that can give rise to affiliate nexus under section 6203, subdivision (c)(5) by utilizing contractual terms and factual certifications; defining the terms "advertisement," "individual," "person," "solicit," and "solicitation" for purposes of applying section 6203, subdivision (c)(5); and providing examples illustrating the application of the new affiliate nexus provisions of section 6203, subdivision (c)(5); and

- Providing notice that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state. (As discussed in detail above.)

Furthermore, the proposed amendments to Regulation 1684 are consistent with section 6203, as amended by AB 155, the proposed amendments will become operative when new section 6203 becomes operative on September 15, 2012, or January 1, 2013, and shall not have a retroactive effect, and the proposed amendments will not impose any new taxes or expand any retailer's use tax collection obligation beyond that imposed by new section 6203 when the amendments made to section 6203 by AB 155 become operative (as discussed in detail above). Therefore, the Board has determined that the adoption of the proposed amendments to Regulation 1684 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. The Board has also determined that the adoption of the proposed amendments to Regulation 1684 will not affect the health and welfare of California residents, worker safety, or the state's environment.

In addition, the forgoing information provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1684 will not have a significant adverse economic impact on business.

The proposed amendments may affect small business.